R9050-3
3/7/89

TAX FOUNDATION'S VOL. 33, NO. 1 JANUARY/FEBRUARY 1989

TAX·FEATURES

Election Year Politics and Fallout From TRA'86 Dominate 1988 Federal Tax Scene

Fiscal Condition of Most State And Local Governments Improves

Many states improved financially in 1988, primarily due to a strong national economy and various tax increases enacted in 1987. However, a few large states suffered severe deficits. California, Connecticut, Massachusetts, and New York contended with revenue shortfalls ranging from $250 million to over $1 billion during 1988.

State and local governments collected $421.8 billion in taxes during the 12 months ending March 1988, an increase of 8 percent, or $31.2 billion, over the previous year. State tax collections totaled $259.7 billion, up 8.3 percent, and local government taxes netted $162.1 billion, showing a 7.5 percent rise. Thirty-four states raised taxes, mostly on sales taxes covering motor fuel, tobacco, alcoholic beverages, and general sales.

High Court Decisions

State and local governments suffered a setback in their borrowing efforts under *South Carolina v. Treasury Secretary*. The court ruled that the provision in the Tax Equity and Fiscal Responsibility Act of 1982 which denies Federal income tax exemption for interest earned on long-term publicly offered state and local bonds not issued in registered form violates neither the Tenth Amendment and principles of Federalism nor the doctrine of intergovernmental tax immunity. The bond registration requirement was intended to prevent Federal tax evasion and money laundering schemes. It has proved successful since no state or local government has since issued any bonds in other than registered form.

In a controversial case with potentially wide-ranging consequences, *D.H. Holmes Co. v. Louisiana Secretary of Revenue and Taxation*, the court unanimously ruled that Louisiana's use tax on merchandise catalogs ordered from out-of-state by a Louisiana retailer and shipped to prospective customers within the state does not violate the Commerce Clause of the Constitution.

Despite $909.0 billion in revenues in FY'88, a 6.4 percent increase over 1987 collections, the Federal government left itself with a budget deficit of $155.1 billion, exceeding the 1987 deficit by $5.4 billion. Due to the stubborn budget deficit that represents over 3.3 percent of total Gross National Product (GNP), pressure continues to mount to raise taxes or cut government spending in order to reduce the red ink in Federal government accounts. It may seem surprising that 1988 saw no major legislation to combat the problem, but there are several reasons why this issue has been side-stepped.

First, since 1988 was an election year, major tax-raising legislation was politically untimely. The budget "summit" between the Administration and Congress, convened in the wake of the 500-point drop in the stock market on October 19, 1987, conveniently worked out a two-year deficit reduction plan to avoid election-year tax manipulation. The budget summit culminated in the Revenue Act of 1987 which called for $8 billion and $14 billion in new tax revenues for FY'88 and FY'89, respectively.

Secondly, the public is still absorbing the impact of the Tax Reform Act of 1986 (TRA'86) which radically changed the Tax Code for individuals and corporations. Since many of TRA'86's provisions are staggered over five years, its full effects will not be felt until 1990 or later. Another major tax act in 1988, attempting to address the budget deficit, could not have gained enough political momentum, especially if it involved increasing the income tax rates established in 1986.

Faltering NEC

Thirdly, no major deficit reduction legislation was witnessed in 1988 because of the appointment of the National Economic Commission (NEC) late in 1987 to address the deficit problem. The 14-member, bipartisan panel, comprised of business, labor, and Congressional leaders appointed by the President and Congress, is scheduled to report its deficit reduction recommendations in March of 1989. But many budget observers predict its report will be kept on ice pending the course of direct deficit reduction discussion between the Bush White House and the Congress. Substantive tax increase options are unlikely in the wake of President George Bush's "read-my-lips" pledge not to raise taxes and subsequent declaration that he would

(Continued on page 2)

THIS ISSUE:

PAGE 1:
Tax Action '88: Federal, State & Local
PAGE 3:
"Budget Watch"
PAGE 5:
"Front Burner"
International Tax Action '88
INSERT:
Avoiding Budget Limitations

(FEDERAL TAXES, *from page 1*)

not support any tax increases proposed by the Commission.

Catastrophic Care

On July 1, 1988, the Medicare Catastrophic Coverage Act of 1988 was signed into law. The act was designed to shield elderly Americans from the financial burden of acute illness, and will significantly expand the Medicare program by limiting the amount that Medicare's 33 million beneficiaries must pay for hospitalization and doctors' services.

The benefits contained in the Medicare Catastrophic Coverage Act of 1988, estimated to cost about $31 billion between 1988 and 1993, are paid for primarily by the people who are expected to be beneficiaries of the program. Payment is made in the form of (1) increased income taxation of Medicare-eligible individuals called the "supplemental premium" and (2) increased part B monthly premium rates (also called the "flat" premium). The supplemental premium is intended to provide approximately 63 percent of the catastrophic and drug benefit financing, while the flat premium is expected to finance the remaining 37 percent of the program.

Many tax analysts consider the new supplemental premium a poorly disguised progressive tax increase since the act will boost the amount the nation's higher-income senior citizens owe the Internal Revenue Service by as much as $1,600 per couple in 1989 and up to $2,100 in 1993. Poorer seniors will pay as little as $96 a year per couple. Higher-income Medicare beneficiaries are required to pay a 15 percent surcharge on their Federal tax in 1989, rising to 28 percent in 1993. The surcharge will be imposed only on recipients with incomes high enough to require the payment of Federal taxes of more than $150 — representing about half of all couples. In the final analysis, the Catastrophic Coverage Act will require senior citizens to pay an additional $19 billion to the IRS over the next five years.

Technical Corrections

The only general tax legislation passed in 1988 was the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) signed by President Reagan on November 11, 1988. TAMRA put an end to the two-year long battle involving technical corrections to TRA'86 and other recent tax laws, as well as extending sought-after expiring tax breaks. Some of the major extensions and modifications include:

- Extension of tax exclusion for employer-provided educational assistance for 1988.
- Modification to expand the low-income rental housing tax credit.
- Extension of the states' authority to issue qualified tax-exempt mortgage bonds.
- Extension of the 20 percent research tax credit allowed for qualified research expenditures incurred in carrying on trade or business.
- Extension of the business energy tax credits for solar, geothermal, and ocean thermal property.
- Extension of the targeted jobs tax credit.
- Modification of mutual fund shareholder expenses to exempt them from taxation.

The Losers

TAMRA will pay for the extended tax breaks by raising more than $4.1 billion over three years, primarily by accelerating payments of corporations' estimated taxes, curbing limited premium life insurance policies that were seen as tax shelters, and restricting loss transfers by Alaskan native corporations. TAMRA also put into place a temporary 15 percent excise tax on a company's withdrawals of pension surpluses to discourage the use of such assets by the company or another company that seeks to acquire it.

Defense Takes a Hit

TAMRA targeted defense contractors recently under attack for defense procurement scandals, extracting from them $1.3 billion over a three-year period — almost one-third of the act's $4.1 billion revenue increase. Defense companies and other long-term contractors unsuccessfully fought the provision restricting the popular tax-deferral accounting technique known as the completed contract method of accounting. This method allows contractors to delay paying part of their taxes on income received from a contract until the contract has been completed. TAMRA now allows only a 10 percent tax deferral as opposed to the 30 percent income tax deferral previously allowed. Single-family homebuilders are exempt from this new provision and can continue to use the completed contract method of accounting to defer taxes. TAMRA will also raise revenues by establishing a 45-cent-a-pound excise tax on pipe tobacco. Persons who use their home as an office will get less of a tax break, and deducting the base cost of a telephone that is also used for personal purposes will no longer be allowed.

Another important provision included in TAMRA was the removal of the limit on the amount of long-term bonds that the Treasury can issue. This provision was sought by the Administration in order to finance the national debt which reached over $2.6 trillion by the end of FY'88 — representing over $10,600 for every man, woman, and child in the United States.

Taxpayer Bill of Rights

TAMRA established the first Taxpayer Bill of Rights, which gives taxpayers specific rights in dealing with the IRS, provides procedures for taxpayers regarding the IRS, adds levy and lien provisions, and extends the tax court's jurisdiction. The Taxpayer Bill of Rights allows a taxpayer to be represented by a CPA, attorney, or other person authorized to appear

(Continued on page 6)

Tax Features

Tax Features (ISSN 0883-1335) is published by the Tax Foundation. Original material is not copyrighted and may be reproduced. Please credit Tax Foundation.

Chairman of the Board ..... James Q. Riordan
President ..... Robert C. Brown
Senior Vice President .... Edward A. Sprague
Editor ..... William J. Wilson
Contributing Editor ..... Allen Schick
Contributing Economist .... Paul G. Merski
Consulting Economist ..... Elsie M. Watters
Publications Specialist ..... William Ahern

Tax Foundation
One Thomas Circle, N.W., Suite 500
Washington, D.C. 20005
(202) 822-9050

Budget Watch By Allen Schick

Government Sponsored Enterprises

The Next Crisis in Federal Budgeting?

No sooner does the Federal government move to control one budget loophole that another one, wider than the first, pops open. If any new proof is needed of this perennial budget problem, it is amply provided by the recent popularity of GSEs, one of the most obscure and least understood areas of Federal budgeting. GSEs—shorthand for government sponsored enterprises—operate in the twilight zone between the public and private sectors. The GSEs are private institutions established by the Federal government to channel credit to certain sectors of the economy. Their hybrid status enables the GSEs to escape both the discipline of the market and the effective control of government.

The Ambiguous Status of GSEs

Government sponsored enterprises are private corporations chartered by the United States Government to perform certain "public" functions. Most of them are financial intermediaries; they provide credit to (or purchase the financial assets of) banks and other institutions which in turn make loans to farmers, homeowners, and students. There now are ten such enterprises, twice as many as there were in 1986. Some of the enterprises are well-known; others (especially those recently established) operate in obscurity. Half of the enterprises have acquired humanoid names: Fannie Mae (Federal National Mortgage Corporation), Sallie Mae (Student Loan Marketing Association), Freddie Mac (Federal Home Loan Mortgage Corporation), Farmer Mac (Federal Agriculture Mortgage Corporation), and Connie Lee (College Construction Loan Insurance Association).

The GSEs borrow and lend truly prodigious amounts of money each year. They handle about $400 billion a year, have loan portfolios that exceed those of the largest American banks, and provide much more credit than the combined total of all Federal agencies. Direct lending by Federal agencies (which is included in the budget) has dropped in recent years, reversing several decades of steady growth. This development may be due to installation of a credit budget system which limits the volume of loans that can be made or guaranteed by Federal agencies. But as government credit has been somewhat controlled, the GSEs have more than picked up the slack. In 1988, the government issued $27.2 billion in loans, sharply down from the $52.8 billion issued only three years earlier. It also guaranteed $100.7 billion in private loans. But the GSEs made $378.1 billion in loans, almost double the amount issued only four years earlier.

Table 1 plots the explosive growth of GSE credit activity during the 1980s. At the end of the decade, the government sponsored enterprises are making more than four times as many loans as they were making at the start of the decade. As a consequence, there has been an astounding buildup in the volume of GSE loans outstanding, from only $182 billion in the 1981 fiscal year to an estimated $719 billion in fiscal 1989. Since these enterprises do not generate their own resources through business activity, they must borrow money in order to be able to lend it out. Consequently, there has been a steady rise in GSE debt, the amount owed to others. This debt now stands at approximately three quarters of a trillion dollars.

GSE credit activity far outstrips that of the Federal government itself. As recently as 1981, however, the government was issuing and guaranteeing more loans directly than through the enterprises. In 1981, GSEs had a smaller volume of direct loans outstanding than the government. Today, however, the GSE loan portfolio is three times larger than the Federal government's. Similarly, in 1981, GSEs' outstanding loans totaled only about half the size of federally-guaranteed loans; today, they are almost one and a quarter times the size.

The GSEs have become a dominant force in U.S. credit markets, especially in agriculture and housing—two credit-hungry sectors of the economy. In 1987, these enterprises accounted for one out of every six dollars advanced or borrowed in the credit markets. This penetration, as Table 2 shows, is almost three times greater than it was in 1983.

Because they are deemed to be private, the transactions of these enterprises are excluded from the Federal budget. However, financial statements and other material pertaining to the

(Continued on page 4)

Table 1

Lending And Borrowing by Government Sponsored Enterprises

(dollars in billions)

	Fiscal Years								
	1981	1982	1983	1984	1985	1986	1987	1988	1989est
GSE Loans	$ 119.2	$ 151.7	$ 169.4	$ 200.6	$ 260.0	$ 391.0	$ 427.5	$ 378.1	$ 391.1
GSE Loans Outstanding	$ 182.3	$ 225.6	$ 261.2	$ 314.1	$ 369.9	$ 453.3	$ 581.1	$ 666.1	$ 719.5
GSE Loans Outstanding as % of Outstanding:									
Direct Loans	98.5%	108.6%	117.1%	137.0%	143.7%	180.2%	248.1%	300.0%	343.8%
Guaranteed Loans	59.0%	68.1%	71.8%	81.2%	90.2%	100.8%	114.6%	121.1%	122.7%
GSE Debt	$ 161.8	$ 205.5	$ 239.9	$ 294.8	$ 351.6	$ 458.1	$ 569.2	$ 663.2	$ 734.0

Source: U.S. Office of Management and Budget, *Special Analysis* and *Historical Tables*.

(BUDGET WATCH, *from page 3*)

GSEs are annexed to the budget Appendix. The private ownership test appears to provide an objective basis for excluding the enterprises from the budget. But it is not an adequate measure of the Federal government's involvement—financial and otherwise—in the GSEs. Table 3 indicates that all of the enterprises receive substantial benefits from the government not generally available to truly private corporations. Most of the enterprises have a line of credit at the Treasury, have their debt treated as equivalent to Treasury debt by banks, are exempted from SEC registration, and enjoy other valuable privileges. According to the Office of Management and Budget, "due to their perceived 'special relationship' with the Federal government, GSEs historically have been able to borrow in the credit markets at yields carrying only slight premiums above those of Treasury securities of comparable maturity." *The New York Times* (and other newspapers) list the debt of these enterprises as "Government Agency Bonds."

The GSEs are children of crisis. The oldest ones were established during the Depression when the credit markets were closed to most farmers and homeowners. For many years, the Farm Credit System (FCS), set up in 1933, took pride in its private status and boasted that it had not cost the government any money. But when farm income and the value of farm land plummeted in the mid 1980s, FCS was threatened with insolvency. Congress came to the rescue and established three new GSEs, each of which is ostensibly private but benefits greatly from Federal assistance. One of them—the Farm Credit System Financial Assistance Mortgage Corporation—has a $1.5 billion line of credit at the Treasury.

The Federal Home Loan Bank System is another GSE with its hands in Uncle Sam's deep pockets. It oversees the Federal Savings and Loan Insurance Corporation (which, is a government agency included in the budget). In 1988 alone, the Home Loan Bank System wrote more than $30 billion in IOUs, notes and other obligations to finance the liquidation or sale of insolvent savings banks. The status of these obligations (which, according to some estimates, might exceed $100 billion before the savings and loan mess is cleaned up) is uncertain, but one should not be surprised if the government ends up paying a big part of the bill. To help finance the savings and loan crisis, Congress established the Financing Corporation in 1987 and gave this new GSE authority to borrow more than $10 billion.

The law establishing the Financing Corporation states that its bonds are not direct obligations of the United States. But things are not as straightforward as they seem. Default by major GSEs is unthinkable and would probably do more damage to housing and agriculture than would abolition of the Agriculture and Housing and Urban Development Departments.

What should be done to rein in the GSEs before they grow so large as to impose great risks on the financial system? A 1985 study by the Congressional Budget Office identified four options: (1) Increased regulation to limit the risks taken by the GSEs; (2) privatization which would end the special relationship between the enterprises and the government; (3) public ownership which would give the government full control; and (4) imposition of fees on GSEs to reimburse the government for the benefits it provides them and the risks it bears.

Doing nothing is not a viable option. If the government addresses the GSE problem only at the point of crisis, as it has in agriculture and the savings and loan industry, it will have no choice but to make good on the bad debts of others. A good starting point would be to reexamine the status of the GSEs and decide whether they should be subject to the marketplace or to government control. It is no longer responsible to permit them to remain free of both.

Table 2
GSE Participation in U.S. Credit Markets
Selected years

	1973	1978	1983	1987
GSE Loans as % of Total Funds Advanced in U.S. Credit Markets	4.3$	6.6$	6.8%	16.8%
GSE borrowing as % of Funds Borrowed in U.S. Credit Markets	5.3%	5.6%	5.6%	15.9%

Source: U.S. Bureau of the Budget, Special Analysis.

Table 3
Status of Government Sponsored Enterprises

	When Established	Treasury Line of Credit	Exemption from SEC Registration	Treated by Banks as Treasury Debt
Federal Home Loan Banks	1932	Yes	Yes	Yes
Farm Credit System	1933	Yes	Yes	Yes
Federal National Mortgage Association	1938	Yes	Yes	Yes
Federal Home Loan Mortgage Corporation	1970	Yes	Yes	Yes
Student Loan Marketing Association	1972	Yes	Yes	Yes
College Construction Loan Insurance Association	1987	No	Unknown	Unknown
Financing Corporation	1987	No	Yes	Yes
Federal Agriculture Mortgage Corporation	1988	Yes	No	Yes
Farm Credit System Insurance Corporation	1988	No	Unknown	Unknown
Farm Credit System Financial Assistance Corporation	1988	Yes	Yes	Yes

Source: Office of Management and Budget, Budget of the United States Government, Special Analysis F.

TAX FOUNDATION
ONE THOMAS CIRCLE, N.W., SUITE 500

WASHINGTON, DC 20005
TELEPHONE 202-822-9050

FEDERAL TAX POLICY MEMO

Editor: Edward A. Sprague, Senior Vice President—Program Planning and Tax Policy

JANUARY/FEBRUARY 1989

Getting Around the Budget Limitations

Dedicated Financing and Credit Shenanigans

by Rudolph G. Penner
Senior Fellow
Urban Institute

Summary

Rudolph Penner is a Senior Fellow at the Urban Institute and former Director of the Congressional Budget Office. He is a member of the Tax Foundation-sponsored Shadow Committee on the Federal Budget.

In this article Mr. Penner describes why off-budget activity is likely to rise to new heights during the 101st Congress. He sees little hope of avoiding a prolonged impasse between the Bush Administration and Congress on deficit reduction. At the same time there are mounting pressures for more government spending. Penner foresees three strengthening trends as a result: (1) more off-budget Federal action, especially in credit programs and regulatory programs; (2) dedicated, deficit-neutral financing for what new initiatives the Federal government does implement; and (3) transference of more social activism and regulatory zeal to the state/local level. According to Penner, the costs imposed on business by these off-budget activities, including mandated benefits and state regulations, are likely to far exceed the costs imposed on business by any explicit Federal tax increases.

In the credit area, Penner sees more use of government guarantees and financing by government sponsored organizations to avoid the Gramm-Rudman-Hollings deficit limitations. These arrangements still can involve high costs for the Treasury. There are ways to bring the government guarantee process under better control, but government sponsored organizations are a "real growth industry." Bailing out the bankrupt thrifts will undoubtedly resort to an off-budget agency whose borrowings could cost 75 basis points or more above that for regular government bonds. Ultimately it will cost the taxpayers "a heck of a lot of money."

Mr. Penner's remarks were taken from an address to the Tax Foundation's 40th Annual Conference in New York City on November 30, 1988.

I find it hard to look forward to the next budget year with any great enthusiasm. I think that we are likely to see an impasse over the budget about as profound as any that we saw during the Reagan presidency. There is a fairly pronounced demand, at least as evidenced by the public opinion polls, for increased government activism on the one hand and on the other a great reluctance to pay higher taxes. And, of course, the Presidential campaign pandered to these discordant beliefs.

President-Elect Bush's one major fiscal promise is this so-called flexible freeze. I think the easiest way to think about it is to take social security, about 20 percent of spending, out of the picture; take interest, which is about 14 percent of spending, and set it aside; take defense, another 27 percent of spending or so which Mr. Bush wants to hold constant in real terms, and set it aside too. Then the notion of a flexible freeze is that you keep the rest of the budget constant in real terms, the word flexible meaning you can cut some programs and raise others.

If I were to point to the single most important reason that this is not a viable option, it would be the health care programs. The problem is that if we do nothing, if we don't change the health care laws at all, they will grow in

Material in **Federal Tax Policy Memo** *may be reproduced freely. Credit to Tax Foundation would be appreciated.*

real terms by somewhere from 8 to 10 percent per year. And they quantitatively dominate the budget portion that Bush would like to freeze.

Also in that portion are other large programs that are growing fairly rapidly in real terms such as military and civilian retirement. You also have programs like unemployment insurance that tend to grow faster than the rate of inflation.

So what a flexible freeze means is that you either have to radically restructure the programs that are growing rapidly — and there is really no political desire to do that in the Congress — or you just have to cut the smithereens out of the rest of the budget. There is no political will to do that in the Congress either. So if the flexible freeze is not viable and if tax increases are not viable as far as George Bush is concerned, you have the making of this profound impasse.

So what is likely to happen as a result of this impasse? You have, on the one hand a growing demand for more government spending. On the other hand, you have this huge deficit. It seems to me that you are going to see three important trends resulting from this situation.

The first are non-budget or off-budget forms of governmental activism. If you can't do it on budget, then hide it somewhere. And the two major categories of off-budget activity are credit programs and regulatory programs. I will focus more on the credit programs shortly.

A second trend is a much better one, and that is to the extent there are on-budget initiatives, under today's conditions the legislators feel the need to identify resources for them. That is to say new initiatives have to be deficit-neutral, both according to the procedure rules under Gramm-Rudman and more importantly simply because of the political mood, the political constraints on them. So you will see, I think, more things like the catastrophic health insurance plan where you had a tax increase and a premium clearly identified for that purpose. Or if you see a child care plan, you will probably see, as in some of the bills before the Congress, a reduction in the subsidy for child care now contained in the tax system. I don't necessarily mean earmarking, but I do mean an identified financing source.

I think this disciplines the system. It makes it very evident what the costs of programs are. And, indeed, the catastrophic health bill came pretty close to being defeated, in terms of how the political dynamics went once those enormous costs were so clearly identified. So it is disciplining. On the other hand, it's likely to result in a much more complicated tax system when you have special taxes or user fees for this and that. And you are in trouble of you ever make the mistake of identifying a revenue source that brings in too much revenue because you feel obligated to spend it on the earmarked program.

The third trend I see emanating is that to the extent people approach the Federal government for more social activism and are essentially turned away because the Federal government can't afford it, you will see more and more activity shift to the state and local level. The same public opinion polls that seem to demand more spending indicate that people trust state and local government more to spend their tax monies wisely than they trust the Federal government. I think basically it's a very healthy trend. It's actually been going on since the trough of the 1982 recession, but it does mean a very complicated situation for investors because in essence you have to keep track of the tax policies and the regulatory policies for 50 states as well as for the Federal government.

Business Costs

It would be my projection that over the next four years of President Bush's first term that the costs imposed on business by off-budget activities, plus the costs imposed through state and local tax increases and regulatory activities, are likely to far exceed costs imposed on business by explicit Federal tax increases (although there will probably be a few of those of a minor sort). That is why it's so important, I think, to look at these off-budget activities, and, in my view, to try and constrain them as much as possible.

The kind of devices you find off-budget are the sort that make it very hard to enforce any spending limits as implied, say, by Gramm-Rudman-Hollings or would be implied by a balanced budget constitutional amendment. Indeed, we have learned a lot from the state and local sector about how to evade constitutional limits of that sort. They give us lessons every year in new ingenious approaches to that problem.

I'm going to concentrate now on the credit programs. Credit programs are appropriate in certain circumstances. The problem is that the way we keep the accounts of the Federal budget greatly distorts our choice between one credit program as opposed to another. I identify three kinds of credit programs.

(1) There are direct loans usually made at favorable interest rates or subsidized interest rates.

(2) There are guarantees where the Federal government guarantees either 100 percent of a loan against default or some portion such as 90 percent. As an aside here, a lot of people misunderstand what it means when the Federal government guarantees 90 percent of a loan. Often they believe that if any loss is suffered the Feds

pick up 90 cents on the dollar and the private lender 10 cents. That's not usually how it works. It very often works that the Federal government picks up 100 percent of the first 90 percent of the loan value, so that it's very unlikely that the private lender will ever see any defaults. The programs vary, but that's a very typical kind of arrangement.

(3) The third kind of credit program involves government sponsored corporations. I'm thinking here of things like Fannie Mae, Freddie Mac, and now the brand new one, Farmer Mac. [see also Budget Watch, p. 3 of *Tax Features*]

Our budgeting techniques are probably somewhat biased against the first type, direct loan programs, because we keep the Federal budget on this peculiar cash basis and it is to the cash deficit that limits like Gramm-Rudman-Hollings apply. In other words, the first year you make a direct loan to someone, the subsidy value of that loan, essentially 100 percent of the loan, appears in the budget. So the subsidy value or the benefit to the borrowers is greatly overstated. When the loan is repaid, you get the reverse situation. One hundred percent of the repayment shows up in our cash budget.

One of the many ways that the Gramm-Rudman-Hollings deficit targets have been evaded, especially in 1987, was to allow for the early prepayment of loans made in the past. So for example, you have the rural electric cooperatives who had borrowed in the early 1980s from the Federal government at subsidized rate is higher than today's market rate. So like a lot of homeowners they wanted to refinance those loans. Well, it was very convenient for the Federal government to waive prepayment penalties, to take those loans in to meet the Gramm-Rudman-Hollings cash deficit targets.

But it cost the Treasury a lot of money to go through that artificial exercise. We lost the prepayment penalty. We lost the high interest on the loans that we had. Nevertheless, we sort of made the Gramm-Rudman target.

Federal Guarantees

Guarantees are favored by the budget accounting because they have no budget implications whatsoever unless the loan actually goes into default. And most politicians hope that will be after the next election! So there is a bias in budgeting toward the guarantees.

Now I think that CBO and OMB have suggested a rather neat approach to this problem that would improve the Federal budgeting for both direct loans and guarantees and eliminate some of these biases. With regard to subsidized direct loans, CBO and OMB suggest selling them back to the marketplace as soon as you make them. In other words, as a government agency you would make a subsidized loan, you would sell it to the market, and as the market would discount it, the value of the discount would be an excellent measure — if the market was working right — of the subsidy value of that loan, something that's not easy to estimate analytically. You would be substituting the market's view of the credit worthiness of the borrower for the agency's own. You would insist then that whatever agency was issuing this direct loan would go and get an appropriation from Congress to cover the discount. That would be the discipline. And I think it would work a lot better.

Now the critics of this approach say that there is an imperfect market out there for a lot of these loans. The marketplace might not bid their real value. So it is better to do it administratively. Have some bureaucrats estimate what the discount would be if there were a perfect market. This route has problems too, obviously, but it's better than what we do now. And I would certainly settle for it if the Congress felt you would not be able to sell those loans at a fair market price. It varies from program to program. For some of the loan programs, there really isn't a market that's worth anything.

With regard to guarantees, this plan would involve, in the best of circumstances, government going to the private market and trying to reinsure a loan to get the equivalent of private mortgage insurance to cover any future losses on the loan. Again, it's a question of whether a perfect market for that sort of thing would develop. If not, you can again make an administrative estimate of the present value, the expected value of any losses, and you get the issuing agency to deposit those monies into a Treasury fund to cover the losses. You again insist that the agency get an appropriation to cover that amount. So that brings to the situation a discipline that does not exist today.

From Fannie Mae to Farmer Mac

This sort of program should work for direct loans and guarantees, but what about these government sponsored organization? They are really a different animal, and it's much more difficult to figure out any way of controlling them. They are privately owned with private shareholders, but they are government chartered. In some cases, government appoints a share of the board of directors. In some cases, but not all, they have a line of credit from the Treasury, usually very small relative to their total liabilities. I think they have one major feature in common, and that is the belief in the marketplace that the government "ain't going to let these guys go broke no matter what they do." That's probably true.

So given that belief, they are able to borrow on favorable terms. An institution like Fannie Mae is able to

lever itself up to the hilt without paying a significant risk premium. But economic costs of these institutions are obvious. They make it harder for non-favored borrowers in the credit markets. They raise interest rates. But how do control them?

The government sponsored organization is going to be used more and more. It has been used recently to start bailing out the thrifts. It has been used recently to bail out the farm credit system. It's being proposed for small business. It could be a real growth industry.

The particularly worrisome aspect of it is in dealing with the thrift institution problem. Treasury is now concocting a plan that would have a government sponsored institution borrow probably up to $100 billion in the private marketplace. This wouldn't show up in the Federal budget at all. That borrowing would be guaranteed by zero purchase loans, the principle on the borrowing. The Federal government would pay the interest on that debt which would be on-budget. The interest would be on-budget, but the principle would not be.

And the tragedy of this approach — as opposed to just fessing up that we probably made the biggest mistake in the history of the U.S. government with these thrifts and going out and borrowing with regular Treasury bonds — is that while these government-sponsored institutions borrow on favorable rates, they still pay more than the government does, often *75 basis points or so on comparable debt*. So our attempts to hide this thrift fiasco and never to fess up in the budget to what it costs is ultimately going to cost the taxpayer one heck of a lot of money. But I'm afraid that's exactly how we are going to do it.

We have to think of a means of controlling these kinds of institutions or, better still, not create them in the first place.

* * * * *

CBO Baseline Deficit Projections and Targets

(By fiscal year)

	Actual	Base	Projections				
	1988	1989	1990	1991	1992	1993	1994
			(In Billions of Dollars)				
Baseline Projections							
Off-Budget Surplus[a]	$ 39	$ 56	$ 68	$ 79	$ 90	$ 103	$ 117
On-Budget Deficit	194	211	209	219	225	233	239
Total Deficit	155	155	141	140	135	129	122
Deficit Targets	144	136	100	64	28	0	[b]
			(As a Percentage of GNP)				
Baseline Projections							
Off-Budget surplus[a]	0.8%	1.1%	1.3%	1.4%	1.5%	1.6%	1.7%
On-Budget deficit	4.1	4.1	3.8	3.8	3.6	3.5	3.4
Total deficit	3.2	3.0	2.6	2.4	2.2	2.0	1.7
Deficit Targets	3.0	2.7	1.8	1.1	0.5	0.0	[b]

[a] Social Security (Old-Age and Survivors Insurance and Disability Insurance Trust Funds).
[b] The Balanced Budget and Emergency Deficit Control Reaffirmation Act set targets only through fiscal year 1993.
Source: Congressional Budget Office; Economic and Budget Outlook, January 1989.

Tax Reform a Big Hit Internationally in 1988

By lowering top income tax rates and limiting deductions in the Tax Reform Act of 1986, the U.S. seems to have struck up a beat that other nations are marching to; and 1988 is the year that our major trading partners have fallen in step.

Japan

Japan adopted major tax reform legislation that will slash income tax and excise tax rates and included a new 3 percent broad-based sales tax. Taking effect in April 1989, the new legislation will introduce substantial cuts in income, corporate, residence, and inheritance taxes, and tighten taxation on capital gains.

The lower income tax rates will range from 10 to 50 percent as compared to the existing 10.5 to 60 percent range, and there will be five income tax brackets instead of twelve. The base corporate tax rate will be reduced from 42 to 40 percent in fiscal 1989 and then cut further to 37.5 percent in fiscal 1990.

Great Britain

A major tax overhaul introduced with Great Britain's 1988 Budget went into effect in June. The basic rate of income tax was reduced from 27 to 25 percent, and the main personal allowances were increased by 7.5 percent. The upper income tax rate was set at 40 percent for people who make more than U.S. $35,700. The previous top rate was 60 percent for those earning more than U.S. $72,600.

West Germany

The Tax Reform Act of 1990 was approved July 8, 1988. It reduces West German income tax rates for both corporations and individuals. The highest individual rate was reduced from 56 to 53 percent, with corporate rates reduced from 56 to 50 percent. The tax reform focuses largely on personal taxes, as opposed to business taxes, and aims to spur savings and investment by cutting $10.67 billion from the national tax bill.

Canada

The Canadian Tax Reform of 1988 became law September 13, 1988. It reduced the number of personal income tax brackets to only 3 from the previous 10. The 3 brackets — 17 percent on the first Cdn $27,500 of taxable income, 26 percent on the next Cdn $27,500, and 29 percent on all taxable income above Cdn $55,000 — were established with most personal exemptions now converted to tax credits. The law also lowers the general Federal corporate tax rate to 28 percent from the current 36 percent and phases down the rate for manufacturing companies to 23 percent by 1991 from the current 30 percent.

THE FRONT BURNER

By Robert C. Brown
President, Tax Foundation

"Who Owns America?"

Foreign ownership of U.S. assets continues strong and growing, according to the Comerce Department's June 1988 *Survey of Current Business*. To wit:

❒ Foreign investment in the U.S. now totals $1.54 trillion.

❒ More than $344.4 billion of that is invested in corporate stocks and bonds.

❒ U.S. banks owe $539.4 billion to foreigners.

By the same token, it must be said that the United States is no piker when it comes to investing in other nations. The *Survey of Current Business* shows:

❒ Total U.S. assets abroad equal $1.17 trillion.

❒ 1.03 trillion of that is privately held.

❒ U.S. investors own more than $146.7 billion in foreign securities.

The bottom line, of course, is that the United States is in a negative position—*minus* $368.2 billion—as far as international investments go. This may be no reason to stand up and cheer. It is also no reason to weep and gnash our teeth.

For one thing, foreigners are investing in the U.S. because it is a desirable place to invest. We have a strong economy, a stable political system, a dynamic private sector, and a labor force that can produce with the best, given the right tools and equipment.

The problem is not that the U.S. is poor as a place to invest. It is that current tax policy does not encourage Americans to invest—i.e., save—in their own country.

Secondly, it is important to bear in mind that no matter what assets may be owned by foreigners, our dollars do not necssarily leave our shores. We are often talking about the allocation of ownership, not the removal of dollars. Leif H. Olsen, Chairman of the Tax Foundation's Shadow Budget Committee, enjoys telling what happened when J. Paul Getty decided to live in England in the years before his death. That simple choice to change residence caused a significant drop in the offially reported U.S. international investment position, even though Getty had not taken a dime with him when he relocated. It's not as if a fleet of container ships will pull up to a pier some day and haul off the nation's wealth.

A final consideration is that we live in a global economy. When the trade position of the European Economic Community (EEC) solidifies in 1992, we will find out precisely how global that economy is. Those are the rules of the game. Given a fair chance, the U.S. private sector has shown that it can compete successfully. It is up to the policy makers in Washington to see that they receive that chance.

Perhaps the new breeze blowing in our nation's capital will let in a little fresh air regarding two key areas affecting the nation's position in the world economy:

❒ Incentives for savings and investment.

❒ Tax policy that will aid rather than damage the competitive position of U.S. companies.

(FEDERAL TAXES, *from page 2*)

before the IRS. It also requires the Service to establish formal guidelines for what constitutes a reasonable time and place for a taxpayer's interview. Furthermore, the IRS is now prohibited from evaluating the performance of its employees involved in collections by setting quotas for amounts to be collected. The Taxpayer Bill of Rights now gives taxpayers a 30-day "grace period" after notice of intent to levy before the IRS can seize a bank account and increases the amount of property and wages exempt from collection action. Finally, the IRS is given authority to allow installment tax payments if the agreement would facilitate the collection of taxes owed.

. . . the Catastrophic Coverage Act will require senior citizens to pay an additional $19 billion to the IRS over the next five years.

With the passage of the Technical and Miscellaneous Revenue Act of 1988, many of the numerous drafting errors in TRA'86 that bestowed unexpected benefits upon some taxpayers while imposing unintended liabilities upon others were finally resolved. For many individual and corporate taxpayers, TAMRA means more certainty in tax planning than has been possible since passage of TRA'86.

Welfare Reform

In October of 1988, President Reagan signed into law the Family Support Act of 1988. While the main purpose of the new Support Act is to reform the welfare system, it will also have a major tax impact on many individual taxpayers because a portion of the $3.3 billion expense of the bill will be covered through a variety of tax moves. Beginning in 1989, taxpayers claiming the child-care tax credit will be required to report the name, address and social security or other taxpayer-identification number of the child-care provider. This tightening provision is expected to raise $529 million in tax revenues over the next five years from babysitters who are not fully reporting their incomes. Another $25 million is expected to come from taxpayers who must now furnish social security numbers for dependents as young as two years, down from five years under previous law. The new law lowers the maximum age of dependents for whom taxpayers can claim the child-care tax credit raising an estimated $375 million over a five-year period. The largest share of funding for the $3.3 billion welfare reform will come from extending for five years an expiring IRS program under which money owed to the government is deducted from income-tax refunds.

Windfall Tax Repealed

With the passage of the Omnibus Trade Bill, August 23, 1988, the Crude Oil Windfall Profit Tax Act of 1980 was repealed. The act had imposed an excise tax on oil revenues, above a statutory base, that were expected to result from the projected increase in oil prices. However, with reduced and stabilized oil prices the windfall profit tax raised little revenue after 1986 and cost over $100 million annually to administer. Manufacturers and consumers alike will benefit from the repeal of the windfall profit tax, which was viewed as a disincentive to exploration and production of domestic crude and as posing burdensome recordkeeping expenses on producers.

Proceedings of a 1988 Tax Foundation Seminar

"The U.S. Stake in U.S. Foreign Investment"

on tax policy and its effect on U.S. competitiveness abroad will be available in March

64pp $ 10.00
$ 5.00 for members

add $1.00 p/h

Tax Foundation
One Thomas Circle, N.W.
Washington, DC 20005
202-822-9050